

STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 6677

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| Petition of Central Vermont Public Service Corporation) | |
| for Approval of its 2002 Long-Term Incentive and) | |
| Common Stock Purchase Plans) | Hearing at |
| | Montpelier, Vermont |
| | May 28, 2002 |

Order entered: 12/13/2002

PRESENT: Hope G. Crifo, Hearing Officer

APPEARANCES: Kenneth Picton, Esq.
for Central Vermont Public Service Corporation

James Volz, Esq.
for Vermont Department of Public Service

I. INTRODUCTION

On March 26, 2002, Central Vermont Public Service Corporation ("CVPS" or the "Company") filed a petition with the Vermont Public Service Board ("Board") seeking approval to issue a maximum of 350,000 common shares for the purpose of funding the Company's proposed Long-Term Incentive Plan ("2002 Plan"). This amount of shares is expected to last the Company approximately three to five years. The petition was supported by prefiled and oral testimony from Joan Gamble, and accompanying exhibits.¹

In its petition, CVPS is asking for a determination pursuant to 30 V.S.A. §108(a), that the proposed 2002 Plan and issuance of up to 350,000 common CVPS shares is consistent with the general good of the State of Vermont.

In accordance with 30 V.S.A. § 202(f), the Vermont Department of Public Service (the "Department") has determined that the petition is consistent with the Vermont Twenty-Year

1. In response to Board questions, CVPS supplied additional information on June 3, 2002, some of which was filed under seal.

Electric Plan, provided that: (1) CVPS is required to keep a record of stock options exercised by employees of CVPS's non-regulated subsidiaries, and the impact of any such exercises on the equity base of the Company; and (2) such data is submitted to the Department on an annual basis and at the time of a request for a rate adjustment. The Department's determination under 30 V.S.A. § 202(f) also provides that it does not imply approval of the capital structure resulting from the proposed issuance of common shares.

In a letter dated April 26, 2002, the Department waived its rights under 3 V.S.A. § 811 to review a Proposal for Decision provided the Public Service Board adopts the recommendations and conditions contained in the Department's 30 V.S.A. § 202(f) determination.

A hearing was held in this Docket on May 28, 2002.²

Based upon the evidence of record, I hereby report the following findings and conclusion to the Board in accordance with 30 V.S.A. § 8(c).

II. FINDINGS

1. CVPS provides energy services to its customers and is subject to the jurisdiction of the Board. Petition at 1; Gamble pf. at 5.

2. The Company compensates its executives through a package of base salary, bonus and payments under two incentive plans -- an Annual Incentive Plan and a Long-Term Incentive Plan. Tr. 5/24/02 at 25 (Gamble); exh. CVPS Gamble-5.

3. CVPS represents that its incentive plans are important in generating a performance-oriented culture at CVPS rather than a business-as-usual culture in that Company employees receive an incentive when they meet their targets. Tr. 5/28/02 at 56 (Gamble).

4. In 2001, the total cash compensation (includes salary, bonus, restricted stock awards, long-term incentive plan payments and other compensation, but excludes benefits) paid to CVPS's five highest utility operations' executives aggregated \$1.89 million, including \$356,697 in 2001 incentive awards which were paid out in early 2002. The Company's highest paid executive received \$635,150, of which \$86,130 in incentive awards were paid in early 2002. Exh. CVPS Gamble-3, at 20.

2. By agreement of the parties, the May 28, 2002, hearing was conducted as an evidentiary hearing.

The Annual Incentive Plan

5. The Annual Incentive Plan provides all non-union employees a pay-out based on three measures: Company performance; team performance; and individual performance. Regular employees receive between zero to eight percent of salary. Officers receive a higher percentage of salary. Tr. 5/28/02 at 13 (Gamble).

6. The Annual Incentive Plan is geared to align employee and officer compensation with customers' and ratepayers' needs. Tr. 5/28/02 at 12 (Gamble).

7. The Annual Incentive Plan measurements are designed to be a balanced set of measures, which incorporate company-wide financial measures, customer measures, process improvement measures, and individual employee performance. The specific company-wide performance measures for executives include: "cash flow from operating activities"; "corporate balanced business performance"; "strategic business unit/team balance business performance"; and individual performance measures. In addition, executives are also given individual performance scores. Tr. 5/28/02 at 46 (Gamble); CVPS response to Hearing Officer inquiry, June 3, 2002, at 3.

8. The corporate and team performance measurements have three levels: Threshold; Target; and Maximum. No payments are made in a specific measurement category if the Threshold level is not reached. If the Target level is reached, the specified target award is made. If the Maximum level is reached or exceeded, twice the specified target award is made. CVPS response to Hearing Officer inquiry, June 3, 2002, at 3.

9. In 2001, CVPS failed to reach the targeted performance level in each of the three aforementioned corporate and team performance measures. In the performance measure of "cash flow from operating activities", the minimum threshold target was not reached. CVPS response to Hearing Officer inquiry, June 3, 2002, at 3-5.

10. Based on the Company's performance measures, CVPS paid a total of \$552,951 in 2001 to 309 regular employees under CVPS's Annual Incentive Plan. As determined under the plan's targeted performance measurements, ten CVPS officers received \$452,000 in payments in 2001 under the Annual Incentive Plan. Tr. 5/28/02 at 14-15 (Gamble).

11. CVPS will no longer seek to recover in rates the cost of Annual Incentive Plan payments made to officers. Tr. 5/28/02 at 22-23, 28 (Gamble); exh. CVPS Gamble-5.

The Long-Term Incentive Plan

12. Long-term incentive plan awards are made by the Compensation Committee of CVPS's Board of Directors. As of March 2002, CVPS's Compensation Committee had six members, each of which was an outside director.³ CVPS. Exh. 3 at 10.

13. The proposed 2002 Plan is a successor plan to the 1998 stock option plan for non-employee directors. The 2002 Plan also supplements the restricted stock plan for non-employee directors and key employees, and the 1997 and 2000 stock option plans for key employees. As such, it covers ten executive officers, employees, and non-employee directors. Gamble pf. at 4.

14. The 2002 Plan measurements are a continuation of those employed in the previous plan, and are based on stock appreciation, relative stock appreciation, and relative dividend yield. Tr. 5/28/02 at 45 (Gamble).

15. CVPS's proposed 2002 Plan is an omnibus plan that does not distinguish between potential individual specific types of stock awards. The omnibus plan allows granting stock options, stock appreciation rights, restricted stock and performance units.⁴ Gamble pf. at 4, 7; tr. 5/28/02 at 29.

16. Generally, the design of long-term incentive plans does not change frequently. CVPS last looked extensively at its plan's design in 1998. Tr. 5/28/02 at 41 (Gamble); exh. CVPS Gamble-6.

17. There is only an indirect connection between the proposed 2002 Plan and enhancing customer service and lowering costs. Customers and shareholders both benefit from enhancing customer service and lower costs. Tr. 5/28/02 at 51 (Gamble).

3. Subsequent to March 2002, one of the members of the Compensation Committee has resigned from the Compensation Committee and from CVPS's Board of Directors.

4. A stock option allows purchase of shares of common stock at a price not less than the fair market value per share of common stock on the date of grant. Stock appreciation rights entitle the grantee to receive an amount equal to the excess of the Fair Market Value of a share of common stock on the date of the stock appreciation right, multiplied by the number of shares of common stock with respect to which the stock appreciation right shall have been exercised. Restricted shares involve the immediate transfer by the Company to a participant of ownership of the specific number of shares of common stock in consideration of the performance of services, or the achievement of certain performance criteria. Performance units (with each unit representing a monetary amount or such amount represented in shares of common stock as designated in the award agreement) are awards which may be granted to participants alone or in addition to any other awards.

18. A key performance measure of the Company is to provide energy services to its customers while keeping rates as low as possible. Gamble pf. at 5.

19. Some long-term incentive plans at other electric companies and other types of companies include a customer performance component. It makes sense for CVPS to consider including a customer performance component given the adoption of service quality standards. Tr. 5/28/02 at 47.

20. The proposed 2002 Plan rewards employees, officers and non-employee directors with increases in shareholder value. The monetary award that is created through the long-term incentive plan is totally dependent on share price appreciation, dividend yield, and the relative total return on CVPS common stock compared to all other electric utilities. Tr. 5/28/02 at 21 (Gamble); exh. CVPS Gamble-4.

21. The value of the long-term incentive plan awards given out in 2001 exceeded \$300,000. Exh. CVPS Gamble-3; tr. 5/28/02 at 48 (Gamble).

22. Awards under CVPS's long-term incentive plans are not paid for by ratepayers. The long-term incentive plan has always been, and will always be, paid for by shareholders. Tr. 5/28/02 at 23, 28, 51 (Gamble).

23. In calculating its requested authorization of 350,000 shares, CVPS used a rule of thumb that, in total, its employee and director plans account for no more than ten percent of total outstanding stock. The Company looked at the outstanding shares under all of the director and employee plans and compared that to ten percent of CVPS's total outstanding stock, and the difference was 350,000 shares. *Id.* at 40-41.

24. Based on historical awards, the 350,000 share authorization sought by CVPS should last the Company approximately three to five years. Gamble pf. at 6.

25. The 2002 Plan will terminate on May 8, 2012. *Id.* at 6.

26. The Department determined that the proposed 2002 Plan is consistent with the Vermont Twenty-Year Electric Plan provided that the Company will keep a record of stock option exercises by employees of its non-regulated subsidiaries and a record of such exercises' impact on the Vermont-utility equity base, and that such data is to be provided to the Department. Department's 202(f) Determination, filed with the Board on April 25, 2002.

III. DISCUSSION

30 V.S.A. § 108 prohibits any company subject to the Board's jurisdiction from issuing stock without prior Board approval, and requires that such approval be based on a finding that the proposed sale is consistent with the general good of Vermont. In its petition, CVPS is seeking Board approval to issue up to 350,000 of its common shares for use in its 2002 Plan. It follows that approval of CVPS's petition requires the Board to find that the 2002 Plan is consistent with the general good of Vermont.

The 2002 Plan is "intended to strongly ally the interests of Company management with that of customers and shareholders and provide significant incentives for management to meet customer goals and increase shareholder value."⁵ Inconsistent with its intended objective of allying the interest of management with the twin goals of serving customers and increasing shareholder value, the 2002 Plan does not include any provisions which are directly based on customer satisfaction measures. Neither does the 2002 Plan make a link between the granting of incentive awards and the provision of energy services to its customers at rates as low as possible, a key performance measure identified by the Company.⁶ In oral testimony, Witness Gamble stated that the Company's proposed 2002 Plan only indirectly affects service.⁷

Further, the evidence fails to show a link between incentive awards and executive performance. The aggregate value of incentive awards made in 2001 exceeded \$1,304,950, of which more than \$300,000 was made under the Company's Long-Term Incentive Plan. These award payments were made in spite of CVPS's failure to reach the targeted performance level in each of the three corporate and team performance measures.

I am thus unable to make an unqualified finding that the proposed 350,000 share stock issuance and 2002 Plan are consistent with the general good of the state.

The Company itself seems aware of the potential for improvements in the 2002 Plan, and has committed to a process, and established a management committee, to review how awards

5. Gamble pf. at 3-4.

6. Gamble pf. at 5.

7. Tr. 5/28/02 at 51 (Gamble).

under the plan are granted.⁸ The Company has also indicated it intends to review the plan's design elements.⁹ Given the aforementioned pending reviews, I recommend to the Board that it approve CVPS's petition, but limit the amount of common shares to be issued without further Board approval to 250,000 shares. Based on recent award amounts over the past few years, and according to the Company's prefiled testimony, this lesser amount should be sufficient to fund the proposed 2002 Plan for two years.¹⁰ During this period, the Company, in conjunction with the Compensation Committee of the Board of Directors, will have adequate time to review and finalize the design elements of the plan to more closely align them with the plan's stated objectives.

The Department also recommends specific conditions to be included in any approval of CVPS's petition. The Department recommends requiring CVPS to keep track of how many options issued under the 2002 Plan are exercised by non-utility business unit executives, and to report that information to the Department. The Department also recommends that CVPS be required to keep a record of the impact on the Company's equity base of stock options exercised by employees of CVPS's non-regulated subsidiaries. I concur with the Department's recommendations.

With these modifications, I find that the Company's request to issue common shares for use in the 2002 Plan is consistent with the general good of the State of Vermont, if the Board limits its approval to no more than 250,000 shares.

IV. CONCLUSION

Based on the evidence in the record, I recommend that CVPS' proposed issuance of up to 250,000 shares of common stock for use in the 2002 Plan as described be approved, but only with the following conditions:

1. The Company shall separately record and report the effect on the utility's equity base from shares exercised by non-utility business unit executives. I recommend this information be

8. Tr. 5/28/02 at 30-36, 34-35 and 59 (Gamble).

9. Tr. 5/28/02 at 47 (Gamble).

10. Gamble pf. at 6.

submitted as part of any future rate case filing by CVPS, or upon a request from the Department or the Board.

2. CVPS shall not be allowed to recover in its Vermont retail rates any payments related to compensation paid to executives under the Company's Annual Incentive Plan and its Long-Term Incentive Plan.

This Proposal for Decision has been served on all parties to this proceeding in accordance with 3 V.S.A. § 811.

Dated at Montpelier, Vermont, this 11th day of December, 2002.

s/Hope G. Crifo
Hope G. Crifo
Hearing Officer

V. BOARD DISCUSSION

On December 9, 2002, the Department of Public Service and Central Vermont Public Service Corporation filed comments on the Hearing Officer's Proposal for Decision. The Petitioner's comments addressed a number of the Hearing Officer's concerns. The comments were also responsive in that they clarified certain specifics relating to Central Vermont Public Service Corporation's Long-Term Incentive Plan and the composition of the Company's Compensation Committee.

After review of those comments, the Board approves the Petitioner's request to issue 350,000 common shares to fund the Long-Term Incentive Plan.

We do, however, share the Hearing Officer's concern over the seeming lack of a tie between incentive awards and performance.¹¹ Thus, we are ordering the Company to notify the Board at least 45 days before it will make incentive awards under this authorization which will bring the total awards granted under this Order to over 250,000 common shares. At the time CVPS seeks release of the remaining 100,000 common shares now being authorized, the Company will be expected to show the Board and the Department how the incentive awards being made are tied to performance.

V. ORDER

IT IS HEREBY ORDERED, ADJUDGED AND DECREED by the Public Service Board of the State of Vermont that:

1. The findings, conclusions and recommendations of the Hearing Officer are adopted, except as noted above.
2. The Board approves the issuance and sale of up to 350,000 shares of Central Vermont Public Service Corporation's common stock, through its Long-Term Incentive Plan, as described in the petition, prefiled and oral testimony and exhibits, pursuant to 30 V.S.A. § 108.
3. At least 45 days prior to making incentive awards which would result in the issuance and sale of more than 250,000 of the 350,000 shares of Central Vermont Public Service Corporation's common stock described above, the Company shall file with the Board and the Department evidence showing the linkage between the incentive compensation awards and executive performance.
4. Central Vermont Public Service Corporation shall keep a record of the impact on the Company's equity base of any common stock sold to officers and employees of the Company's non-regulated affiliates. This information shall be submitted as part of any future rate case filing by CVPS, or upon a request from the Department or the Board.
5. Central Vermont Public Service Corporation shall not be allowed to recover in its Vermont retail rates any payments related to compensation paid to executives under the Company's Annual Incentive Plan and its Long-Term Incentive Plan.
6. This Order does not constitute approval of any particular capital or operating expenditure, nor the underlying capital structure that Central Vermont Public Service

11. This Board has long taken the position that incentive pay should be true incentive pay as opposed to just a different form of extra compensation. In her oral testimony, CVPS witness Gamble supported this view of incentive compensation.

Corporation may implement. Nothing in this approval shall preclude the Department or any other party, or the Board, from reviewing and/or challenging any related issues in any future proceeding.

Dated at Montpelier, Vermont, this 13th day of December, 2002.

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| <u>s/Michael H. Dworkin</u> |) | |
| |) | PUBLIC SERVICE |
| |) | |
| <u>s/David C. Coen</u> |) | BOARD |
| |) | |
| |) | OF VERMONT |
| <u>s/John D. Burke</u> |) | |

OFFICE OF THE CLERK

FILED: December 13, 2002

ATTEST: s/Susan M. Hudson
Clerk of the Board

NOTICE TO READERS: This decision is subject to revision of technical errors. Readers are requested to notify the Clerk of the Board (by e-mail, telephone, or in writing) of any apparent errors, in order that any necessary corrections may be made. (E-mail address: Clerk@psb.state.vt.us)

Appeal of this decision to the Supreme Court of Vermont must be filed with the Clerk of the Board within thirty days. Appeal will not stay the effect of this Order, absent further Order by this Board or appropriate action by the Supreme Court of Vermont. Motions for reconsideration or stay, if any, must be filed with the Clerk of the Board within ten days of the date of this decision and order.